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Request for Comments – *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*
Actuarial Standards Board
1850 M Street, NW, Suite 300
Washington, DC 20036

To: Actuarial Standards Board (ASB), Request for Comments – *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*

These comments are in response to the request for written comments on the "*Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*." The following comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Community and are being submitted to the ASB by the Steering Committee of the CCA Public Plans Community. However, these comments do not necessarily reflect the views of the CCA Board, the CCA's other members, or any employers of CCA members, and should not be construed as being endorsed by any of the aforementioned parties.

The CCA Public Plans Community (PPC) represents a broad cross section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The PPC includes over 50 leading actuaries whose firms are responsible for the actuarial services provided to the majority of public-sector retirement systems. Our membership includes a diversity of opinions and perspectives on public pension plan valuation issues, such that not all members of our community necessarily subscribe to all of the comments presented here. Nonetheless we believe the overall response reflects a substantial consensus among the actuaries who provide valuation and consulting services to public pension plans.

We are grateful to the ASB for exploring a potential ASOP on *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions* and inviting public-sector actuaries and others to comment on these important issues. We are also grateful to the ASB and Pension Committee for their hard work in striving to understand these complicated and interconnected issues.

Paul Angelo, FSA, FCA, MAAA, EA (By Direction)
Chair of the Public Plans Steering Committee on behalf of the
Public Plans Steering Committee

Steering Committee of the Conference of Consulting Actuaries' Public Plans Community[1]
Response to the Actuarial Standards Board (ASB),
Request for Comments – *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*

We are writing on behalf of the Public Plans Committee of the Conference of Consulting Actuaries to respond to the Actuarial Standards Board's request for comments on the recent exposure draft for *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*.

We would like to begin by thanking the Actuarial Standards Board and its Pension Committee for their consistent approach to these issues and allowing for a variety of comments. Our response addresses the questions posed in this exposure draft on the subject of risk assessment and the methodologies needed in pension practice (in particular how it relates to the public-sector).

Introduction

First, we observe that risk assessment for pension obligations is an emerging practice. As such, there currently are only a few generally accepted risk assessment methodologies in pension practice, and these focus primarily on analyzing and communicating investment risk. The Actuarial Standards Board and the actuarial community could benefit from a Practice Note from the American Academy of Actuaries on the subject of risk analyses appropriate for risks other than investment risk.

1. The discussion draft that preceded this proposed ASOP indicated that a risk assessment should be performed for substantially all pension assignments. The exposure draft has limited the assessment to funding valuations, as defined in section 2.1. Do you believe this limitation is appropriate? Why or why not? If not, what other types of valuations should include risk assessments?

The definition of *funding valuation* in section 2.1 refers to "periodic" measurement of pension obligation which appears to refer to annual (or other recurring) actuarial valuations. There may be other circumstances when a Board of Trustees or plan sponsor needs to determine plan contributions or the benefit levels supportable by specified contribution levels where a risk analysis would be appropriate. In particular, we recommend that the scope of this ASOP specifically include performing cost studies for a benefit change. If risk assessment is necessary for periodic measurements, it would be reasonable to assume risk assessment would be necessary for those other circumstances.

Expanding the scope to other measurements (including cost studies) may require other changes in the proposed standard. If the purpose of the measurement is to study the impact of a change in benefit provisions, perhaps a quantitative risk assessment could be narrowed to factors associated with the benefit change rather than a broad scope of risk assessment that may be needed in an annual actuarial valuation. For example, a proposed change in retirement eligibility may require new retirement rates. A quantitative risk assessment restricted to alternative retirement rates may be more appropriate than a risk assessment on all the factors listed in section 3.2. Different examples of benefit changes would likely generate different appropriate risk factors. The standard could limit the risk assessments for measuring plan changes to the demographic or other assumptions impacted by the change. In some circumstances, a quantitative risk assessment for a benefit change may not be possible or practical. In such cases, a qualitative assessment should be acceptable.

The current scope does not include measurements for accounting purposes, service purchases or other transfers and various employer cost sharing risks other than those associated with plan contributions (e.g., withdrawal assessments). We believe that the current scope is appropriate in these respects and suggest that the Actuarial Standards Board continue to monitor any emergence of practice in these areas.

[1] These comments were developed through the coordinated efforts of the Conference of Consulting Actuaries' (CCA) Public Plans Steering Committee and are being submitted to the ASB by the Steering Committee of the CCA Public Plans Community. However, these comments do not necessarily reflect the views of the CCA Board, the CCA's other members, or any employers of CCA members, and should not be construed as being endorsed by any of the aforementioned parties.

2. Does the language in the exposure draft provide sufficient guidance to actuaries performing risk assessment work? If not, what additional guidance should be provided?

This response is focused on section 3.2 (Risks to be Assessed) and section 3.4 (Methods for Assessment of Risk), noting that sections 3.3 and 3.5 through 3.7 are addressed in other questions.

We believe that the illustrative list of methods in section 3.4 is both appropriate and sufficient.

We believe that the illustrative list of risks in section 3.2 is appropriate and also sufficient with the exception that there is one further type of risk we would propose for the Board to consider: "governance risk related to funding policy." This "governance risk" falls into two categories: an "inadequate funding policy" risk, and a "willingness to pay" risk. As discussed below, we recommend that the former should be added to the list of risks in section 3.2, while the latter should be explicitly excluded from the scope of the standard (along with "ability to pay").

1. One type of funding policy risk is the plan sponsor or other contributing entity's "willingness to pay." This can be a significant risk to the plan's financial condition in situations (e.g., some public-sector jurisdictions) where there is no reliably consistent legal or other regulatory authority that compels funding on an actuarially determined basis. Note this is distinct from but similar to the "ability to pay" that is excluded from the scope of the standard in the last paragraph of section 3.2. We recommend that this "willingness to pay" risk be identified and excluded (along with "ability to pay") by amending the statement at the end of section 3.2 to read as follows:

   > *This standard does not require the actuary to evaluate the ability <u>or willingness</u> of the plan sponsor or other contributing entity to make contributions to the plan when due. In addition, the actuary is not expected to provide investment advice. [Emphasis added]*

2. The other type of funding policy risk results when a plan is funded on a consistent basis but that basis – whether actuarially determined or not –either is not sufficient to fund the expected benefits (even if all assumptions are realized) or else funds the expected benefits on a basis that is not generationally equitable. Examples include: (1) inadequate fixed contributions rates and (2) actuarially determined contribution rates based on funding policies with very long unfunded liability amortization periods. We recommend that this "inadequate funding policy risk" be added to the list of risks in section 3.2.

3. Is the language in the exposure draft sufficiently flexible to allow for new developments in this area of actuarial practice?

Yes, the language is sufficiently flexible. We are not aware of anything in the exposure draft which precludes the addition of new practices in risk assessment as they develop. Neither does the exposure draft preclude the current use of additional methods of risk assessment which are already available and may be appropriate in the practitioner's judgment.

4. Do you agree that the guidance in section 3.3 regarding assumptions used for the assessment of risk should include moderately adverse but plausible outcomes? If no, what guidance would you propose?

We agree that the assessment of risk should include moderately adverse but plausible outcomes. This allows the user to plan for the impact of the adverse events which are most likely to happen, but does not prevent the actuary from adding other outcomes which may be useful to consider.

However, we also believe that the statement should be changed to clarify that it applies to deterministic analysis, not stochastic analysis. Specifically, we suggest it be changed to read "Assumptions used for deterministic assessment of risk should reflect moderately adverse but plausible outcomes." Stochastic modeling generally includes a broader range of potential outcomes.

5. As discussed in section 3.5, for a funding valuation of a plan, the actuary should perform a risk assessment, which may be quantitative, qualitative, or both. Should the guidance require the actuary to use professional judgment in choosing which type of assessment (quantitative, qualitative, or both) to use? For example, if an actuary believes a quantitative assessment should be performed, do you believe providing a qualitative assessment instead of a quantitative assessment should be considered appropriate actuarial practice?

Requiring qualitative assessments of key risks is a reasonable addition to our standards. However, in the case of requiring quantitative assessments, at this time, professional judgment must be the standard. There are valid "best practice" needs for quantitative assessments in many situations. However, there are two reasons for not making this part of the Actuarial Standards of Practice:

1. Not every plan should be required to incur the cost for a material amount of quantitative risk assessment. There is a cost/benefit trade off that must be considered. That is not to say that depending on the type of risk, some quantitative analysis would not be helpful. For example, for some users there can be real value in performing and reviewing a forecast of contribution rates based on stochastic investment returns. However, these require a material amount of work. The complexity (and cost) of the analysis depends on the complexity of the plan design. Smaller plans will face the greatest fee challenges should this be a requirement and may not feel able to justify this additional expense. Trustees can already ask for studies and have a fiduciary duty to decide what is prudent to study.

2. As noted in our answer to question 1, there are few generally accepted risk assessment methodologies in pension practice. There are no established practices for looking at risks associated with demographic assumptions (or any assumption other than investment risks). For that reason, before a standard is promulgated, educational materials on assessing non-investment risks should be developed through Society of Actuaries research and/or an American Academy of Actuaries practice note.

6. Plan maturity measures have been included as a potential disclosure item to assist intended users in understanding the risk associated with the plan. Are there additional measures that may be disclosed that are significant to understanding the risks of the plan? If yes, what measures would you recommend as a disclosure item?

The following changes would clarify and enhance the examples of maturity measures:

1. Add a disclosure of the ratio of total liabilities to payroll. This measure is commonly used to convey the effect to plan contributions due to a change in liabilities. This would be best placed as section 3.6(b) and the remaining items adjusted to be section 3.6(c) through 3.6(e).

2. Change current section 3.6(b) to compare retired life liability to the total plan liability. Representing the retiree liability as a portion of the total liability is more effective for risk studies. For example, plan trustees may decide to use a more conservative investment allocation for retired life liabilities.

3. Define "net cash flow" in section 3.6(c). We believe section 3.6(c) is intended to exclude the investment income. We recommend "net cash flow" be defined as contributions less benefit payments and non-investment expenses, if material.

4. Add an adjustment to section 3.6(d) for non-investment expenses. We recommend changing current section 3.6(d) to read *"the ratio of benefit payments to contributions. If material, non-investment expenses may be included in addition to benefit payments."*

There should be more focus on the maturity measures that are related to major risks. Only the first of the four items in section 3.6 directly addresses a major risk of the plan. The section 3.6(a) ratio of assets to payroll is used to measure the effect of investment risk on plan contributions, while the section 3.6(b) ratio of retired life to active life liabilities is only a measure of plan maturity. The measurements in section 3.6(c) and 3.6(d) only address liquidity risk, which is not usually a significant risk since it can be readily managed.

7. Do you agree with the use of a threshold for requiring mandatory quantitative assessment that is based on the actuary's professional judgment? If not, what threshold do you believe should be used?

We do not agree with the use of a threshold for requiring mandatory quantitative assessment. We question the appropriateness of the use of any threshold that is a "bright-line" type distinction, like the "large plan" criterion proposed in the exposure draft. We feel that any such threshold simultaneously implies a distinct delineation among plans that does not exist and limits the actuary's ability to appropriately apply professional judgment.

Instead of a bright-line threshold, we believe guidelines for the application of professional judgment is the appropriate mechanism for determining when the quantitative assessment outlined in section 3.7 would be required. We believe that this guideline should require the actuary to apply his or her professional judgment to evaluating a number of criteria that represent factors that potentially make quantitative assessment more warranted. We agree with the Board that the criteria currently included in section 3.7 relating to whether or not a plan is a "large plan" should be included within the criteria that the actuary evaluates using his or her professional judgment. However, we also suggest adding the following criteria that should be considered when exercising such professional judgment:

- *The financial condition of the plan and (if provided by others) the financial condition of the sponsor*
- *The plan's risk characteristics, based on measures of plan maturity, the relationship of assets and liabilities to payroll, etc.*
- *The existence of contingent benefits or asymmetric benefits that are difficult to value deterministically*

We strongly believe that basing the evaluation of whether a plan should be subject to a mandatory quantitative assessment on our proposed guideline instead of a bright-line threshold will improve this proposed standard for two reasons:

1. It will enable practitioners to use their professional judgment more effectively, allowing the standard to be more dynamic in its response to emerging risks and environments, and

2. It will better reflect the continuum of risk assessment needs such as when a larger well-funded plan with a self-adjusting design may have fewer needs than a smaller plan with asymmetric plan designs.

8. Do you believe that the term "large plan" in section 3.7 is sufficiently clear that an actuary will be able to apply it in practice? If not, what clarification would you suggest? Are there other characteristics that should be specified in determining "large plan"?

If the "large plan" criterion is used as a "bright-line threshold" in determining if a plan is required to perform a quantitative assessment, we believe that additional guidance will be required to make it sufficiently clear for an actuary to apply in practice. Under the "bright-line" approach, the actuary's professional judgment is to be used to categorize the plan in only one of two ways: either the plan is a "large plan," or it is not. Essentially, the actuary is required to determine if the plan is a "large plan" as defined by the standard.

An example of the additional guidance that would be necessary to give actuaries sufficient clarity to make a definitive conclusion as to whether a plan is a "large plan" under the "bright-line" regime would be to specify how some types of plans with multiple employers are to be evaluated. Some major risks are not shared by different employers[2] in public-sector "agent" plans. For such plans, the ASB should provide guidance on whether "largeness" should be evaluated for the plan as a whole or separately for each agent employer. Another example of an area where we think additional guidance would be necessary under the "bright-line threshold" approach is providing guidance on whether professional judgment can be used to evaluate the identified factors relative to each other or whether they should each be evaluated in isolation. An example of this would be whether it is appropriate for an actuary to use their professional judgment to conclude that a supplemental plan does not meet the large plan bright-line threshold. While a supplemental plan may have a large number of members (factor a in section 3.7 of the exposure draft), the relative size of the liabilities is generally low even given the number of members.

In contrast, using our proposed "multiple criteria" approach (instead of the single "bright-line threshold"), the actuary would be evaluating the plan and sponsor as a whole, including the size of the plan, using their professional judgment and would not have to reach a definitive conclusion as to whether a plan is a "large plan." Under this approach, the current characteristics listed for the "large plan" criterion would be sufficient.

9. Is every five years an appropriate period for performing a mandatory quantitative assessment for a "large plan" in the absence of significant changes, as described in section 3.7?

We suggest that the quantitative risk assessment be performed as often as needed to convey the risk being analyzed, effectively leaving this to professional judgment. ASOP Nos. 27 and 35 do not require analysis on any schedule. Instead, existing standards require that the actuarial assumptions be reasonable for the purpose of the measurement. The less specific conditions in ASOP Nos. 27 and 35 leave room for the actuary to exercise professional judgment. Clearly evaluating the appropriateness of the current valuation assumptions is a greater priority than projecting future risks, and yet the ASOPs have no specific requirement for the frequency of experience studies.

Section 3.7 also says that if, in the actuary's professional judgment, significant changes have occurred since the last assessment was performed that would make the results of that assessment inappropriate, the actuary should perform a new quantitative risk assessment. This requirement presumes that the principal will automatically be willing to pay for a

[2] Our concern is most keen with public-sector "agent" plans where there is a large investment pool made up of many small plans, each covering one employer and for which the assets of one agent plan cannot be used to pay the benefit of a participant in another agent plan.

new risk assessment. It may be preferable to modify this language to say that the actuary should advise the principal that the prior risk assessment is no longer appropriate, can no longer be relied upon, and that the principal should consider a new quantitative risk assessment.